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memorandum

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subject: Leveraged "Forward Contract"

This Chief Counsel Advice responds to your request for assistance dated April 25, 2014. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =
Promoter =
HoldingCo =
Advisor =
Broker =
HoldingSPE =
BrokerSPE =
Foreign Bank =
HoldingSPE2 =
PromoterLLC1 =
PromoterLLC2 =
PromoterLLC3 =
Agent =
TaxpayerLLC =

LawFirm	=
SoloP	=
SoloPP	=
State A	=
State B	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Month 1	=
Month 2	=
Month 3	=
Year 1	=
Year 2	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 13	=
Year 17	=
Year 21	=
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H	=
I	=
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K	=
L	=
M	=

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<u>O</u>	=
<u>P</u>	=
<u>Q</u>	=
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<u>V</u>	=
<u>W</u>	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
<u>AA</u>	=
<u>BB</u>	=
<u>CC</u>	=
<u>DD</u>	=
<u>EE</u>	=
<u>FF</u>	=
<u>GG</u>	=
<u>HH</u>	=
<u>II</u>	=
<u>JJ</u>	=
<u>KK</u>	=
<u>LL</u>	=
<u>MM</u>	=
<u>NN</u>	=
<u>Oo</u>	=
<u>PP</u>	=
<u>QQ</u>	=
<u>RR</u>	=
<u>SS</u>	=
<u>TT</u>	=
<u>UU</u>	=
<u>VV</u>	=
<u>WW</u>	=

XX =
YY =
ZZ =
AAA =
BBB =
CCC =

ISSUES

1. Whether the Service may use the substance-over-form doctrine to recast the form of a transaction in order to disregard a loan and the portion of a purported forward contract that offsets the loan?

2. Alternatively, whether the "at-risk" rules set forth in I.R.C. § 465 apply to limit Taxpayers' losses claimed in connection with the transaction?

3. Alternatively, whether any component of the transaction that Taxpayers invested in is a "conversion transaction" pursuant to I.R.C. § 1258?

CONCLUSIONS

1. The Service may disregard the form of the transaction, which in substance was the purchase of a swaption contract. The loan was designed to be offset by the provisions of a purported forward contract, with nothing ever really borrowed or repaid. The Service may disregard the loan as lacking genuineness under recent case law that addresses similarly circular flows of purportedly borrowed money. Likewise, the Service may disregard the form of the forward contract, which comprised a component designed only to repay the loan, and a component that functioned like a swaption rather than a forward contract. The facts in Rev. Rul. 2003-97, 2003-2 C.B. 380, are distinguishable.

2. If the Service is not permitted to recast the transaction, Taxpayers' claimed losses may be limited under section 465 as Taxpayers appear to have no amounts at risk. The breadth of the loss limitation will depend upon further development of facts concerning Taxpayers "activities," as that term is used in section 465(b) and (c). Given Taxpayers' activities, as reflected on their return for the year in issue, Taxpayers' investment in the transaction appears unrelated to any trade or business conducted by Taxpayers.

3. If the Service is not permitted to recast the transaction, section 1258 will treat gains that Taxpayers report with regard to the purported forward contract as ordinary income up to the "applicable imputed income amount" (as defined in section 1258(b)). Section 1258 applies generally to transactions that are

marketed as converting the return on the time value of money into capital gain. Taxpayers invested in a transaction that converted the time value of money into capital gain through the form of a purported forward contract that was designed to mirror payments owed on a loan. Moreover, materials used to market the transaction demonstrate that the transaction was sold as producing capital gains from what was a guaranteed interest-like return on the time value of money.

FACTS

This memorandum addresses a transaction marketed and sold under the label, "Leveraged Forward Contract," or, alternatively, the "[Promoter] Shield" (hereafter the "Transaction"). The Transaction consists of two legs: a loan obligation (hereafter the "Loan") and prepaid derivative contracts (hereafter the "Contracts"); as explained, infra, the Loan and the Contracts are designed to create offsetting rights and obligations. Though the Loan and Contracts were entered into in Year 1, Promoter purchased both the Loan and Contract elements of the Transaction in Year 5 and Year 6, and then marketed the Transaction to individuals for the Transaction's "tax efficiency." Taxpayers in this case are among the investors who purchased an interest in the Transaction. This memorandum considers the purported tax benefits arising from the Transaction as claimed by Taxpayers, a married couple filing jointly, on their return for taxable Year 6.

Origins of the Transaction in Year 1

HoldingCo was a developer of real property in State A, specializing in the construction of luxury beachfront condominiums. HoldingCo's business plan was to construct one condominium complex every four years. At its peak activity, HoldingCo had twenty full-time employees.[1]

In Year 1, HoldingCo's owners engaged Advisor, a financial advisor, to assess the company's interest rate risk. Advisor holds a doctorate in Economics and was, for a time, on the Finance faculty of a large university. Advisor was, and remains, the sole principal of a financial advisory firm.

Advisor maintains that his primary objective was the identification of financial instruments that could effectively mitigate, at an acceptable price, HoldingCo's exposure to rising interest rates.[2] He determined that interest rate caps and swaps met HoldingCo's effectiveness and affordability criteria for an interest rate hedge.[3] Advisor initially proposed that HoldingCo acquire four successive tranches of interest rate caps

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[1] HoldingCo ceased operations and liquidated in Year 4.

[2] The Service has interviewed Advisor while developing the facts in this case. We recognize that Advisor's recollection of the Transaction's origins may be self-serving.

[3] An interest rate cap is an option that provides a payoff when a specified floating interest rate is above a certain level, whereas an interest rate swap is an exchange of a fixed interest rate on a notional amount of principal for a floating rate on that same principal. John C. Hull, Options, Futures, and Other Derivatives 783 (7th ed., 2009).

and swaps, with quarterly deliveries to match HoldingCo's business cycle. He determined that a $N notional amount, coupled with protected rates ranging from O% to R% across the tranches, offered the desired protection. According to Advisor, however, HoldingCo's management preferred to use a forward contract to manage its interest rate risks, and so instructed Advisor to devise a suitable transaction.[4]

The planned forward contracts required the participation of a broker-dealer to execute the transaction. HoldingCo and Advisor selected Broker to provide these services. The parties agreed to incorporate a loan to accompany the forward contract in order to increase, though leverage, the amount of assets referenced by the contract. HoldingCo agreed to have Advisor structure the Transaction to its current form – Broker would sell a prepaid forward contract to HoldingCo and lend to HoldingCo amounts needed to pay the contract's purchase price. The resulting forward contracts,[5] and the loan used to make the required upfront payment, are the Contracts and Loan that serve as the two legs of the Transaction.

To execute the transaction, Broker and HoldingCo each created special purpose entities ("SPE") to act as transaction parties. On Date 1, Year 1, Broker formed BrokerSPE, and HoldingCo formed HoldingSPE. BrokerSPE acted as the counterparty and "seller" of four successive tranches of Contracts to HoldingSPE, and acted as lender of the Loan to HoldingSPE. HoldingSPE acted as the counterparty and the "buyer" of the Contracts and the obligor on the Loan that it used to pre-pay its future obligation under the Contracts.

Specific Terms of the Loan and the Contracts

Advisor planned the Transaction so that the Contracts would require the quarterly delivery of a specified "bond," or its cash equivalent, in exchange for a predetermined price. The bonds, specified as LIBOR-based variable-rate certificates of deposit,[6] would be subject to a "protected" minimum floor rate, thereby providing HoldingCo with protection against increases in interest rates beyond a threshold rate. Advisor created each Contract to be deep-in-the-money (i.e., HoldingSPE pre-paid its future obligation with proceeds from the Loan), and each Contract's quarterly cash-settled amounts are, at a minimum, sufficient to offset the Contract's predetermined price on each payment date. The amounts of the prepayments are reflected on Table II.

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[4] A forward contract is a contract that obligates the holder to buy or sell an asset for a predetermined delivery price at a predetermined time. Hull, supra note 3, at 781. As discussed, infra, the form of the Transaction is needlessly complex. Since HoldingCo is not under examination, we do not address whether HoldingCo's motivation for entering into the Transaction was primarily tax related.
[5] As explained, infra, the contracts do not operate like forward contracts, and we do not concede that these contracts qualify as forward contracts for tax purposes.
[6] The term "LIBOR" refers to the London Interbank Offered Rate. The Contracts define the referenced "bonds" as 3-month LIBOR bank deposits issued by a bank that is a member of the British Bankers Association, and whose deposit rates are used in the association's LIBOR spot fixing.

The Loan had an initial principal amount of $A, and called for sixty-four quarterly installments of interest and principal, payable as follows:

Table I

Period	**Quarterly Loan Payment**
Date 2, Year 5 to Date 3, Year 9	$ B
Date 2, Year 9 to Date 3, Year 13	$ C
Date 2, Year 13 to Date 3, Year 17	$ D
Date 2, Year 17 to Date 3, Year 21	$ E

As originally executed in Month 1, Year 1, the Loan's interest was set at F% per annum with interest computed on a 360-day year basis. An amendment agreed to three years after the Loan's execution retroactively reset the interest rate to G% as of the loan inception date. The amendment explained that a clerical error misstated the intended interest rate in the original loan and security agreements. Although the Loan was executed in Month 1 of Year 1, the first payment on the Loan was not due for nearly four years, on Date 2, Year 5.[7]

The Contracts required HoldingSPE to make upfront prepayments as follows:

Table II

Contract effective dates (16 quarterly deliveries per contract)	**Required Prepayment Due in Year 1**
Date 2, Year 5 to Date 3, Year 9	$ H
Date 2, Year 9 to Date 3, Year 13	$ I
Date 2, Year 13 to Date 3, Year 17	$ J
Date 2, Year 17 to Date 3, Year 21	$ K
	Total: $ L

On the first day of each calendar quarter, beginning Date 2, Year 5, and ending Date 3, Year 21, the Contracts obligated BrokerSPE to deliver to HoldingSPE bonds of a certain face amount or their cash equivalent, and HoldingSPE was obligated to pay an additional strike price of $M.[8] The transactional documents refer to BrokerSPE's payment obligation as the quarterly "Bond Delivery Face Amount," and the Contracts' Confirmation Statements compute

[7] This deferral created original issue discount ("OID"). IRC § 1273(a)(1) and (a)(2).
[8] As explained, infra, neither HoldingSPE nor its successors in interest to the Transaction ever pay the strike price out-of-pocket.

the face amount of bonds to be delivered (or their cash equivalent) to HoldingSPE on the payment dates as follows:

> Bond Delivery Face Amount = The Notional Amount times {(1 + [MAXIMUM (Protected Rate, Market Rate)/4]) x [1 + (LIBOR Rate/4)]}, for the LIBOR Rate on such Bond Delivery Date.
>
> Where,
>
> Notional Amount: $<u>N</u>
>
> Strike Price: $<u>M</u>
>
> Protected Rate: For each of the four Contracts, <u>O</u>%, <u>P</u>%, <u>Q</u>%, and <u>R</u>%[9]
>
> Market Rate: Determined at the Observation Date (a single date occurring shortly before effective date of each of the Forward Contracts)

The formula for computing the Bond Delivery Face Amount thus compares the then-current market interest rate to the Contracts' Protected Rates, and uses the higher rate to compute a quarterly interest rate, which is added to one, and then multiplied by the $<u>N</u> notional amount, resulting in a product.[10] Consequently, if the Market Rate increases above the amount of the Protected Rate, HoldingSPE would receive an additional Bond Delivery Amount. If the Market Rate remains below the Protected Rate, HoldingSPE is assured of a Bond Delivery Amount based upon the Protected Rate, which functions as a floor. The Contracts thus provide for a payout (or delivery) formula tied to two discrete factors: (1) the face amount of the bonds times a guaranteed Protected Rate that was set in excess of LIBOR when HoldingSPE and BrokerSPE first entered into the Contracts (hereafter, the "Protected Rate Payment"); and (2) a potential additional payment of interest, multiplied by the same face amount, if the Market Rate exceeds the Protected Rate (hereafter, the "Additional Payment").

The net Bond Delivery Amount payable to HoldingSPE on the payment date would be the Bond Delivery Face Amount, less HoldingSPE's strike price in the amount of $<u>M</u>. The Protected Rated added to one, then multiplied by the notional amount ($<u>N</u>), then less the strike price ($<u>M</u>), will always yield an amount equal to the quarterly payments on the Loan, as set forth in Table I. Accordingly, the parties fashioned the Contracts so that the net Bond Delivery Amount will at least be equal to, and will offset, HoldingSPE's obligation under the Loan. In this regard, the Loan's terms permit BrokerSPE to offset its required net Bond Delivery Face Amount Payments against HoldingSPE's Loan

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[9] The 3-month LIBOR rate in Month 1, Year 1 (the month in which the parties entered into the Transaction) was <u>S</u>%. Thus, the parties set the Protected Rates (i.e., the rate that HoldingSPE was assured of receiving) between <u>T</u> and <u>U</u> basis points higher than then-current LIBOR rates.

[10] For example, it the Notional Amount is $100, the Protected Rate is 5%, and the Protected Rate is higher than the Market Rate, the Bond Delivery Face Amount will be $100 x (1 + .05) = $105.

payments. The Loan specifically provides that the payments due and receivable on the Contracts and the Loan will be deemed paid upon the parties' making appropriate entries in their books and records. The Loan's terms also provide that BrokerSPE has the right to assign all or part of the loan to any financial institution.

Broker required that it have no transaction risk. Under the terms of the Contract, however, Broker was potentially liable for Additional Payments to HoldingSPE were interest rates to increase above the Protected Rate. To eliminate Broker's transaction risk, Advisor offset Broker's payment risk by arranging a series of four swaption contracts written by Foreign Bank.[11] Written to match the Contracts' payment terms, the swaption contracts' terms reference the same Market Rates, Protected Rates, and notional amount specified in the Contracts. Thus, swaption payments due from Foreign Bank to BrokerSPE were expected to match the amount and timing of any Additional Payments due from BrokerSPE to HoldingSPE under the Contracts.

The swaption contracts' contingent payments are determined as follows:

> {(Market Fixed Rate – Fixed Rate) * $<u>N</u> (the Notional Amount) * [3] * [30/360]}.
>
> Where,
>
> The Fixed Rate is equal to the Protected Rate specified by the Contracts.

The swaption contracts were entered into on the same day that the Loan and Contracts were entered into, and the total cost for the swaption contracts was $<u>V</u>, which reflects only .<u>W</u>% of both the prepayment cost under the Contract and the amount that HoldingSPE borrowed through the Loan in order to finance the Contract's prepayment. Stated otherwise, of the amount that HoldingSPE borrowed and prepaid for the Contracts, only .<u>W</u>% was attributable to the potential that the Contracts would make Additional Payments in excess of the Protected Rate. Although BrokerSPE was the nominal buyer of the swaption contracts, the $<u>V</u> purchase price for the swaption was provided by HoldingSPE as part of its out-of-pocket costs that it incurred at the outset of the Transaction.[12]

Accordingly, upon execution of the Transaction, BrokerSPE held two assets: the Loan and the swaption contracts. As noted, payments from these assets exactly offset BrokerSPE's payment obligation under the Contracts, both in timing and amount. The present value of the cash flow from BrokerSPE's assets (the Loan and the swap) will be equal to the present amount of its liability under the Contracts, such that the assets and liabilities net to zero. Consequently, for GAAP purposes, BrokerSPE reported a net

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[11] A swaption is an option that grants the purchaser the right, but not the obligation, to enter into an interest rate swap where a specified fixed rate is exchanged for a floating rate. Hull, <u>supra</u>, at 790.
[12] The swaption contracts' aggregate purchase price equals the difference between the aggregate value of the Contracts, ($ <u>L</u>) and the amount borrowed under the Loan ($ <u>A</u>). Thus, HoldingSPE's payment for the Contract included an out-of-pocket payment to Broker equal to the cost of the swaption.

zero balance sheet result with respect to the Loan, swaptions, and Contracts. Likewise, upon execution of the Transaction, HoldingSPE held one asset (the Contracts) and one liability (the Loan). Again, for GAAP purposes, the Contracts and Loan offset one another, resulting in HoldingSPE reporting a net zero balance sheet result.

When creating the Transaction, Advisor developed a number of complex computational spreadsheets that depicted the operation and inter-related nature of the payments on the Contracts, Loan, and swaption contracts. Advisor's spreadsheets confirm that the Transaction achieved its desired results and the elimination of Broker's payment risk. One spreadsheet reflects that the executed Transaction generates $X of interest expenses and $Y of capital gains over its expected 20-year life.[13] Approximately AA%, (or $BB) of the interest expense arises within ten years of the Transaction's inception, while approximately CC% (or $ DD) of the gains arise in Transaction years eight through twenty. Beginning in Year 13, the spreadsheet reflects that the Transaction generates capital gains that will exceed annual interest expenses until the Transaction is completed in Year 21.

As noted, HoldingSPE made an out-of-pocket payment at the outset of the Transaction in the amount of $V to pay for BrokerSPE's swaption. HoldingSPE made an additional $EE payment to BrokerSPE as an advisory fee. Other than HoldingSPE's one-time payment to BrokerSPE, there is no record or indication that the parties to the Transaction ever exchanged cash payments or any other type of consideration. Thus, at the outset of the transaction, HoldingSPE's only out-of-pocket costs were for: (1) transaction fees; and (2) the cost of the swaption contracts.

Promoter's Acquisition of the Transaction

HoldingSPE ceased all business activity and liquidated its business operations in Year 4. HoldingSPE, by and through its successor interest holder, HoldingSPE2, sold its entire interest in the Contract to Promoter and three Promoter-controlled limited liability corporations (together referred to as "PromoterLLCs") over a one year period, as shown in Table III below.

Table III

Period	Purchase Price	% Ownership	Buyer of Transaction
Date 4, Year 5	$ FF	GG%	PromoterLLC1
Date 5, Year 6	$ HH	II%	PromoterLLC2
Date 6, Year 6	$ JJ	KK%	PromoterLLC3
Date 4, Year 6	$ LL	MM%	Promoter

[13] Thus, the spreadsheet reflects that anticipated interest expenses exceed the expected gains by $ Z. Advisor, however, has provided several revised computations of expected gain inherent in the Contract.

Total	$ <u>NN</u>[14]	100%	

The sale agreements provided as follows: (1) HoldingSPE, by and through the successor interest holder HoldingSPE2, would assign to Promoter and PromoterLLCs its right, title, and interest under the Contracts; (2) Promoter and PromoterLLCs would assume HoldingSPE's obligations under the Loan; and (3) BrokerSPE would grant its consent to such assignment and assumption.

Once Promoter and PromoterLLCs began acquiring an interest in the Transaction, representatives of Promoter began marketing participations in the Transaction by marketing membership interests in each PromoterLLC to investors.

Individuals' Investment in the Transaction

<u>1. Marketing Materials</u>

Promoter's marketing of the Transaction in Year 5 began through seminars to the investing public. Promoter renamed the Transaction as "[Promoter] Shield". Promoter's representatives marketed the Transaction as a tax strategy with no risk, although the marketing materials also mention the Transaction's effectiveness as protection against rising interest rates. For example, potential investors received a "Risk Management Consulting Technical Discussion," which describes the transaction as follows:

> For the initial price you pay for the Forward Contract, it only pays profits, <u>and never requires Client to come out of pocket for any additional money</u>. The loan is fixed for the entire term, and the loan payments are matched to the minimum payments guaranteed by the Forward Contract. The Client will never have a negative cash flow event.

[Emphasis added]. Slides in a PowerPoint marketing presentation from a Month 3, Year 5 seminar explain the transaction as follows:

Wealth Protection
Not an "investment" No market risk Only pays owner if risk materializes More like "Wealth Insurance"

[14] Given that the total paid by Promoter and PromoterLLCs closely approximates the amount that HoldingSPE paid for the swaption in Year 1, we assume that Promoter's cost for acquiring the Transaction is the approximate value of the swaption contract as of the date of purchase.

Leveraged Forward Contract:
• Long-term protection against risk • Positive Cash Flow after one year • $Millions of benefits through term • Even if interest rates never rise • “Hit lottery” if interest rates do rise

The slides also set forth tables explaining how the annual return from the Contract will always provide for payments on the Loan, and will provide potential additional payments if LIBOR rates increase above the Contracts' Protected Rate. One slide contains “Fixed Schedules of Interest & Gains” where aggregate interest accruing on the Loan over sixteen years offsets aggregate capital gains generated by the Contracts, except that the interest is front loaded in the earlier years, while the capital gains are reported in later years. The presentation emphasizes the “positive cash flow” and the “$Millions of benefits through term,” even if interest rates never rise, thus indicating that Promoter marketed the Transaction as providing cash flow through tax benefits, rather than through the Contracts' “lottery” payments (i.e., Additional Payments).

The slides also explain the “Tax Attributes” of the Loan as generating ordinary deductions in the amount of interest expenses, and of the Contract as generating long-term capital gain attributable to amounts received from the Contracts. A slide sets forth projected “Net After-Tax Cash Flow (if interest rates <u>never</u> exceed <u>[Oo]</u>%),” and projects “Net Cash Flow” in the amount of $<u>PP</u>, due solely to the difference between the “Income Tax Savings” from the Loan interest deducted against ordinary income at an assumed 35% tax rate, and the “Capital Gain Tax” imposed on the Contract's payments at a 15% rate. This expected after-tax cash flow far exceeds the investor's upfront cost.

Accordingly, the promotional materials emphasize how investors in the Transaction are expected to receive a return on their investment primarily through tax benefits, rather than through potential Additional Payments from the Contract if Market Rates exceed the Protected Rate.

<u>2. How the Individual Investors Participated</u>

Promoter marketed the Transaction to individual professionals (e.g., teachers, doctors, lawyers). Investors seeking to participate could do so in one of two ways. First, the investor could sign a subscription agreement and become a limited partner in one of the PromoterLLCs. The LLCs were partnerships for tax purposes and Promoter was the managing member of the LLCs. The LLCs reported items of income, deduction, gain or loss attributable to the Transaction directly to LLC members. Alternatively, investors seeking to participate after Date 7, Year 6 were required to “directly” invest in the Transaction by owning a ratable share of the Contract and assuming a ratable portion of the Loan's liability.[15]

Investors received a one-tenth of one percent (0.1%) interest in the Transaction for every $QQ paid to Promoter. For example, an investor could acquire a 0.7% interest in the Transaction for $RR. Thus, during the period in which Promoter and PromoterLLCs were purchasing elements of the Transaction from HoldingSPE2 for a total of $NN, Promoter was marketing and selling the Transaction and its accompanying tax benefits for a total of $M, more than ten times Promoter's and PromoterLLCs' purchase price. To enter into the Transaction, each investor had to execute four documents: a Participation Agreement, a Nominee Agreement, a Co-Ownership Agreement, and an Assignment, Assumption, and Consent Agreement.

The Participation Agreement formalized the investor's intent to enter the transaction, and contains a risk analysis assessment performed by Advisor. The Nominee Agreement appointed Agent as the investor's exclusive representative with respect to the transaction. Agent acts as nominee for the investor in all matters concerning the Contracts, the Loan, and any other matter relating to the Transaction. The Co-Ownership Agreement states that the Transaction will not be treated as a corporation or a partnership, but that all proceeds, benefits, profits and losses, will be distributed by Agent, as nominee, to the investor for the investor's pro rata ownership share of the Transaction. The Assignment Agreement sets out the investor's percent interest in the Transaction, and provides BrokerSPE's and HoldingSPE's consents to assign to the investor an ownership interest in the Transaction.

For a hypothetical investor with a baseline annual income of $270,000, Advisor recommended the purchase of a SS% interest in the transaction for $70,000, which was allocated as follows: accounting $7,800, (11%); acquisition consulting: $8,400 (12%); commission: $600 (1%); legal: $13,200 (19%); placement fee: $3,000 (4%); risk analysis: $9,000 (13%); structural consultation: $18,000 (26%). The remaining $10,000 (14%) was the purported cost of the Contracts. Thus, for every dollar paid by the investors, only fourteen cents went to purchase an ownership interest in the Transaction.

3. Taxpayers' Participation in the Transaction

Taxpayers (referred separately as "Taxpayer-X" and "Taxpayer-Y") were married and filed a joint income tax return for Year 6, the taxable year in issue. Taxpayer-X was a full time a manager at a manufacturing plant in Year 5, and was laid off in Year 6. Taxpayer-Y reported Schedule C activities on the Year 6 return for both voice-over work

[15] On or about Date 7, Year 6, the largest of PromoterLLCs dissolved, due to Promoter's concern that the LLC would be treated as an "Investment Company" under the Investment Company Act of 1940, Pub. L. No. 76-768. Upon such dissolution, each former member of the LLC now held his or her interest in the Transaction directly by assignment, rather than indirectly through a partnership. Promoter continued to market the Transaction, but sold the Transaction to investors through a purported direct co-ownership in the Loan and the Contracts.

and for officiating over weddings. In Year 5, Taxpayer-Y became interested in real estate investment, and attended a real estate investment seminar. Taxpayer-Y learned about Promoter and the Transaction when one of Promoter's employees made a presentation regarding asset protection during the seminar.

Taxpayers considered the Transaction for a year, and decided to participate. One of Promoter's principals advised that Taxpayers first form a single member LLC (a disregarded entity) through which Taxpayers could invest in the Transaction. Promoter assisted Taxpayers by transferring ownership of TaxpayerLLC, and Taxpayers used the LLC to purchase a TT% interest in the Transaction.[16] Accordingly, Taxpayers paid $UU for a TT% interest in a transaction that HoldingSPE had entered into in Year 1 for a total cost of $V, and which HoldingSPE had sold to Promoter in Years 5 and 6 for a total cost of $NN. Thus, Taxpayers paid more than ten times for their portion of the Transaction than Promoter had paid during the previous year, and more than seven times the amount that HoldingSPE paid in Year 1.

Taxpayers' individual note schedule illustrated the payment offsets of the Loan and the Contract from Date 4, Year 6 through the expected end of the Transaction on Date 4, Year 21. The schedule sets forth the amount of Taxpayers' expected tax savings from their first four years of participation in the Transaction as follows on Table IV:[17]

Table IV

Year	Tax Savings[18]
Year 6	$ VV
Year 7	$ WW
Year 8	$ XX
Year 9	$ YY
Total	$ ZZ

Thus, Promoter marketed the transaction to Taxpayers so that Taxpayers could expect to recoup the cost of the Transaction through tax savings alone within the first two years of the Contract, and would more than triple their investment within four years, again, solely due to expected tax savings.

Taxpayers committed to purchase their interest on or about Date 8, Year 6,[19] and funded the purchase in full on Date 7, Year 6 with a wire transfer from an IRA account

[16] Promoter had formed TaxpayerLLC, a State B company, several months before Taxpayers entered into the Transaction. One of the Promoter's principals emphasized to Taxpayer-Y through a webinar that the most tax efficient vehicle to deduct the interest from the Transaction would be to use a flow through entity such as a single member LLC.

[17] The Examination team has not determined why the offset schedule shows the capital gain income at ordinary rates in Year 6 whereas the Transaction documents refer to the income from the Contract as capital gain. We assume that this is because Promoter at that time held the Transaction for less than one year, and all gains from the Contracts would be short term capital gains. § 1222(1).

[18] This assumes the highest Federal income tax rate for Year 6, i.e., 35%.

to Promoter. Consistent with other investors in the Transaction, Taxpayers never made any additional payments once they completed the upfront investment; their obligations under the Loan and rights to payments under the Contracts offset, dollar for dollar.[20] Taxpayers received a year-end statement from Promoter showing their share of interest expense and capital gain for Year 6. Taxpayers were allocated income and interest expenses from the Transaction from the day Promoter purchased the Transaction on Date 4, Year 6, although Taxpayers did not purchase their participation in the Transaction until Month 2 Year 6, seven months later. Consistent with other direct investors in the Transaction, Taxpayers reported the following items from the Transaction on Schedule C of their individual income tax returns for Year 6:

Gross receipts	$ AAA
Other Interest expense	$ BBB
Legal and professional fees	$ CCC

With respect to "Legal and professional fees," Taxpayers allocated $DDD of their $UU upfront investment cost to "Legal and Risk Management Consultation Expense," pursuant to a letter dated Date 9, Year 6 from Promoter's President. This is consistent with the discussion, supra, that Advisor arranged the Transaction so that investors would typically allocate 14% of their upfront investment to the actual purchase of the Transaction.

Taxpayers still owned their interest in the Transaction in Year 7, but did not include the Transaction's items of income and deductions on their Federal income tax return. In early Year 8, Taxpayers sold their interest in the Transaction back to Promoter.

The Legal Opinions Regarding Tax Consequences of the Transaction

Taxpayers purportedly relied on the following two legal opinion letters, provided as part of the "[Promoter] Shield Subscriber Book": (1) an unsigned draft opinion by LawFirm LLP, a large international law firm, and (2) an opinion by a solo practitioner, SoloP LLC. The LawFirm letter is dated Year 2, well before Promoter or Taxpayers purchased an interest in the Transaction, while the SoloP letter is dated Year 5, the year in which Promoter began marketing the Transaction to individual investors. The letters are not addressed to Taxpayers, nor do the letters specifically address Taxpayers' situation.[21]

With regard to the investors' motivation for entering into the transaction, the LawFirm letter explains:

[19] Few of Taxpayers' agreements or contracts for the Transaction are dated.
[20] The Market Rate during Year 6 was less than the Protected Rate, so Taxpayers were not entitled to any Additional Payments under the Contracts.
[21] The tax opinion letters by LawFirm and SoloP were written for other parties whose names are been redacted.

> We understand that you are concerned that an increase in interest rates will decrease your income from [a hedge fund investment] and will reduce the relative value of the income you receive. You have also indicated that you are concerned that increased interest rates will significantly increase the expense of the mortgage on the [left blank]; reducing the net cash flow you receive from that investment.

Likewise, the SoloP letter explains:

> Due to your concern about the increasing threat of high interest rates due to a significant rise in the money supply and the detrimental effect that rising interest rates would have on [Transaction investor's company], you engaged a financial consultant with an expertise in risk mitigation, [Advisor], to analyze your situation and the available means of reducing those risks.

Each letter contains the same or similar legal conclusions on four issues:

1. It is "more likely than not" that [the Loan] will be treated as indebtedness for Federal income tax purposes, and original issue discount on the Secured Loan will be deductible as it accrues.

2. It is "more likely than not" that no taxable income will be recognized on [the Contract] until the forward sales are executed or it is disposed of in a taxable transaction, and that any gain or loss recognized on forward sales or termination of [the Contract] will be capital gain or loss.[22]

3. It is "more likely than not" that [the Contract] will be treated as part of [another Transaction investor's] investment or business activity for purposes of the at-risk rules of section 465, and that, for purposes of determining whether deductions for expenses relating to [the Contract] and [the Loan] are limited by the at-risk rules, you may take into account your entire investment.

4. It is "more likely than not" that the deduction of interest expense expected to result from the combination of [the Loan] and [the Contract] will be respected and that their separate treatment not be disallowed under the economic substance doctrine.[23]

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[22] The LawFirm letter used the term "accrue," rather than "recognize," and refers to the "termination" of the Contract rather than the execution of forward sales. The legal opinions' discussion of the issue focuses on applicability of section 1258.

[23] The LawFirm letter does not mention the "separate treatment" of the Loan and the Contract in its conclusions. We are currently considering application of the economic substance doctrine to this case, and may issue supplemental advice.

Taxpayers also consulted with attorney SoloPP, who does not have any special tax knowledge or experience. In the consultation with SoloPP, Taxpayers did not disclose all of the facts regarding the transaction, and SoloPP provided no written advice.

LAW AND ANALYSIS

Issue 1: Whether the Service may use the substance-over-form doctrine to recast the form of the Transaction in order to disregard the Loan and the portion of the Contract that offsets the Loan?

The substance of a transaction, not its form, governs its tax treatment. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The Supreme Court has explained that "[a] given result at the end of a straight path is not made a different result because reached following a devious path." Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). "In applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). The Supreme Court has further explained that "the simple expedient of drawing up papers" is not "controlling for tax purposes when the objective economic realities are to the contrary." Id. (citing Commissioner v. Tower, 327 U.S. 280, 291 (1946)).

Section 163(a) allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Due to the Transaction's design to produce circular flows of cash through the offsetting Loan and Contracts, the Transaction raises the question as to whether the Loan and Contracts should be respected as separate transactions for tax purposes. Particularly, where a transaction involves a purported loan that is offset by another element within the transaction, courts have addressed whether the loan is genuine indebtedness, or whether the form of the purported loan should be either disregarded or recast to reflect the objective economic realities of the transaction.

A. Whether the Loan is genuine indebtedness

In Blue Flame Gas Co. v. Commissioner, 54 T.C. 584 (1970), the taxpayer leased assets to a lessee that simultaneously purported to loan money back to the taxpayer. The parties structured the terms of the lease and the terms of repayment of the loan so that the taxpayer's payments due on the loan would offset the lessee's rent due on the lease; no cash would actually change hands, and the respective payments were mere bookkeeping entries. The Tax Court concluded that the proceeds from the purported loan were, in reality, prepaid rent. In so doing, the court noted that the loan was in the exact amount of rent due under the leases, and that the repayment dates of loan and rental payments were intentionally designed to coincide. Id. at 596.

More recently, courts in the "lease-in, lease-out" ("LILO") and "sale-in, lease-out" ("SILO") line of cases have refused to acknowledge the genuineness of purported loans that are entirely offset by other components of a larger transaction.[24] In BB&T Corp. v. United States, 523 F.3d 461 (4th Cir. 2008), the taxpayer claimed tax benefits associated with a LILO transaction whereby the taxpayer purported to lease property from a lessor that then subleased the property back from the taxpayer. The taxpayer paid $18.2 million at the outset of the transaction, of which $6.2 reflected a fee to the lessor and $12 million was placed in an account that invested in government bonds for the taxpayer's benefit. The taxpayer also financed its obligation under the lease by borrowing $68 million and immediately placing the proceeds of the purported loan into an escrow account at a bank that was affiliated with the lending bank; the loan was nonrecourse and the taxpayer could not access the proceeds in the escrow account.[25] The lessor netted its right to receive rent from taxpayer through the lease and its obligation to pay rent to the taxpayer through the sublease, such that "[t]he net result is that no funds change hands during this period; only a circular intrabank transfer occurred. Id. at 468. The court summarized the facts as follows:

> The practical effect of this scenario would be no different than if [the taxpayer] had invested in the treasury bonds directly, except that [the taxpayer] paid roughly $6 million to [the lessor] as incentive for participating in the transaction, as well as various transaction fees, and would have received tax deductions for rent, interest, and amortization of transaction-related fees . . . ."

Id.

The court in BB&T, employing substance-over-form principles, rejected the form of the transaction, including the taxpayer's claims for deductions with respect to rent and interest. In rejecting the taxpayer's claims for interest expenses under section 163(a) with respect to the $68 million loan, the court concluded that the loan did not constitute "genuine indebtedness." Id. at 476. In so doing, the court explained as follows:

> Despite the loan documents providing that [the taxpayer] had a legal obligation to repay $68,008,236 to [the bank], the transaction does not in fact require the taxpayer to pay any money to [the bank]. [The taxpayer], having immediately returned a sum equal to the amount [the bank's parent] supplied in furnishing the [bank] loan to a deferred account at [bank parent], has relieved itself of any further repayment obligations.

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[24] The Service addressed LILO transactions in Rev. Rul. 2002-69, 2002-2 C.B. 760, modifying and superseding, Rev. Rul. 99-14, 1999-1 C.B. 835. LILOs involve taxpayers obligated under leases of property that the taxpayer finances through loans, but where the taxpayer's obligations under the leases and loans are offset through subleases of the property. The ruling, relying upon the substance over form doctrine, holds that claimed deductions for rent and interest are not allowable. The ruling explains: "Where parties have in form entered into two separate transactions that result in offsetting obligations, the courts often have collapsed the offsetting obligations and recharacterized the two transactions as a single transaction." Id. at 762.

[25] The bank that held the proceeds in escrow also provided the proceeds for the loan on behalf of its affiliated bank, so that the bank was "actually paying itself." BB&T, 523 F.3d at 468.

Id.[26] The court further explained that the taxpayer neither compensated the bank for "the use or forbearance of money,"[27] nor did the bank actually forebear any money, because the purported loan was nonrecourse and the taxpayer immediately returned the proceeds back to the lending bank, who then accounted for the loan off of its balance sheet. Id. With respect to the $18.2 million that the taxpayer paid out-of-pocket at the outset of the transaction, the court noted: "All [the taxpayer] has done is paid [the lessor] approximately $6 million dollars to sign documents meeting the formal requirements of a lease and sublease, arranged in a circular transfer of funds from and then back to [the bank], and invested approximately $12 million in government bonds." Id. at 475. Thus, the fact that the taxpayer had the potential to earn an interest-like return on a small component of the transaction did not confer substance upon the purported loan that the taxpayer used to finance the lease.

In Wells Fargo v. United States, 641 F.3d 1319 (Fed. Cir. 2011), the court likewise rejected a SILO transaction[28] on substance-over-form grounds. The facts are similar to those in BB&T: The taxpayer purported to lease property from a tax exempt entity and prepaid the purported rent in part by borrowing money through a nonrecourse loan. The taxpayer's obligations under the lease and the loan were offset by the tax exempt entity's agreement to sublease the property back from the taxpayer. The portion of the taxpayer's prepayment that was attributable to proceeds from the nonrecourse borrowing was set forth in a restricted "debt portion" account that the tax exempt entity used to make payments on its sublease. The term of the sublease and sublease payments were structured to meet taxpayer's debt service obligations under the nonrecourse loan. In this regard, the court referred to the debt portion account as "loop debt," and described the funds in the account as existing "for the purpose of paying off the debt." Wells Fargo, 641 F.3d at 1321. The taxpayer also used its own funds to make a portion of the prepayment, which was placed into an "equity portion" account that invested in high-grade debt for the taxpayer's benefit. The court observed that "[t]he net result is the same as if the taxpayer had simply invested its equity portion account in high-grade debt, receiving a predictable return on that investment over the life of the sublease. Id.

The court in Wells Fargo, in denying the taxpayer's claimed deductions for interest incurred on the nonrecourse loan, explained as follows:

> [W]e are left with purely circular transactions that elevate form over substance. The only flow of funds between the parties to the transaction was the initial lump

[26] The court in BB&T declined to address whether the transaction as a whole lacked economic substance, but held that "the Government was entitled to recognize [the transaction] for what it was, not what [the taxpayer] professed it to be." BB&T, 523 F.3d at 477.

[27] The Supreme Court has defined "interest on indebtedness" as "compensation for the use or forbearance of money." Deputy v. du Pont, 308 U.S. 488, 498 (1940).

[28] A SILO differs from a LILO in that the initial lease is for a term lasting longer than the useful life of the leased asset; thus, the Service treats the initial lease as a sale of the asset for tax purposes. Wells Fargo, 641 F.3d at 1321.

> sum given to [the seller and lessee] as compensation for its participation in the transaction. [Text omitted]. These transactions were win-win situations for all of the parties involved because free money – in the form of previously unavailable tax benefits utilized by [the taxpayer] – was divided among the parties.

Id. at 1330. That the taxpayer received a safe, interest-like rate of return on a portion of its prepayment did not affect the court's conclusion that the SILO transactions ran afoul of the substance-over-form doctrine. Specifically, with respect to the taxpayer's claim for interest deductions, the court noted that the debt "only existed on a balance sheet." Id.

In Altria Group, Inc. v. United States, 658 F.3d 276 (2d Cir. 2011), the court relied upon both the substance-over-form and the economic substance doctrines in rejecting the taxpayer's claimed deductions attributable to SILO and LILO transactions that were structured similarly to those described in BB&T and Wells Fargo. The court refused to recognize that the nonrecourse loans, which taxpayer used to finance a portion of its prepayment under a lease, were "genuine." Altria, 658 F.3d at 290. The court noted that although the loan balance was less than the value of the collateral security, the transaction eliminated any possibility that the taxpayer would default on the loans, the parties' obligations were circular, and the taxpayer never obtained use of "the purportedly loaned funds." Id. at 290-91. The court "agree[d] with the district court that, as here, '[a] pointlessly complex transaction with a tax-indifferent counterparty that insulates the taxpayer from meaningful economic risk of loss or potential for gain cries out for [substance over form] treatment.'" Id. at 291 (citing Altria Group, Inc. v. United States, 694 F. Supp. 2d 259, 272 (S.D. N.Y., 2010)).

Turning to the Taxpayers' claim for interest deductions arising from the Transaction, Taxpayers must first establish that the Loan was genuine indebtedness for the use or forbearance of money. Considered in light of the opinions in Blue Flame, BB&T, Wells Fargo, and Altria Group, the characteristics of the Loan, together with the Contract, lead to the conclusion that the Taxpayer never incurred genuine indebtedness for tax purposes. In so doing, we note the following similarities between the Transaction and the applicable case law: (1) the Loan and the Contracts together were netted as bookkeeping entries with no cash actually being exchanged and no proceeds actually borrowed; (2) the Loan and the Contracts were circular insofar as the original parties to the Transaction structured it so payments on the Loan and the Contracts would match precisely in both timing and amount over the Transaction's duration; (3) the Loan was effectively nonrecourse since the assets that secured the Loan (the Contracts) made all Loan payments; (4) there was no risk of default on the Loan; and (5) the Loan and the Contracts together added needless complexity to a transaction that could have provided the parties with identical results in a cheaper and more straightforward fashion.

The fact that Taxpayers had the opportunity to obtain a potential return based upon the Contract's Additional Payment provisions confers no more genuineness upon the Loan than did the taxpayers' interest-based rate of return on a portion of their out-of-pocket investments in the LILO and SILO cases. Like the taxpayers in BB&T and Wells Fargo, Taxpayers made a relatively small out-of-pocket payment for an arguably profitable element of the Transaction, and then claimed interest deductions on the Loan that far exceeded Taxpayer's out-of-pocket payment. Indeed, at the outset of the Transaction in Year 1, the value of the possibility that the Contract would make additional "lottery" payments (if Market Rates increase beyond the Protected Rate) was reflected in the value of the swaption, an amount that was only .W% of the Loan's initial principal balance. Like the taxpayers in BB&T and Wells Fargo, Taxpayer used no portion of the Loan to acquire the arguably profitable component of the Transaction; rather, Taxpayers paid out-of-pocket for their share of the swaption held by BrokerSPE.[29]

Accordingly, the practical effect of this transaction is no different than if Taxpayer had simply purchased the swaption directly from Foreign Bank, except that Taxpayer paid substantial fees to Promoter to access interest deductions that would be otherwise unavailable. See Wells Fargo, 641 F.3d at 1330. Therefore, the Loan must be disregarded, regardless of whether other components of the transaction, such as the potential for Additional Payments, are respected. When disregarded, there is no genuine indebtedness, and therefore, Taxpayers are not permitted to claim interest deductions on the Loan.

B. Whether the Contracts must be respected

In form, the Contracts were styled as forward contracts. Given the Contracts' intended operation to offset the Loan, we turn to whether the form of the Contracts should be respected for tax purposes.

Case law defines a forward contract as "an executory contract calling for the delivery of property at a future date in exchange for a payment at that time."[30] Anschutz v. Commissioner, 135 T.C. 78, 81 (2010), aff'd, 664 F.3d 313 (10th Cir. 2011); see also Hull, supra notes 3 and 4. A forward contract does not result in a taxable event until the future sale referenced in the contract is actually executed. Lucas v. North Texas Lumber, 281 U.S. 11, 13 (1930). The potential gain or loss inherent in a forward contract reflects the difference between the contract's agreed-upon sales price for the asset and the asset's current value (the "spot price"). See Hull, supra note 3, at 5. If the form of the Contracts as forward contracts is respected in this case, then gain attributable to the quarterly Bond Delivery Face Amount payments may be taxed as capital gain and may be deferred until the Contract's actual payment dates.[31]

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[29] Likewise, the out-of-pocket amounts that HoldingSPE and Promoter paid when entering into the Transaction similarly reflected the value of the swaptions.

[30] The Service has recognized that certain forward contracts may be prepaid while retaining the tax treatment of a forward contract (rather than as a current sale). Rev. Rul. 2003-7, 2003-1 C.B. 363.

[31] Even if the Contracts are treated as forward contracts, however, some or all of the gains (assuming the amounts otherwise qualify as gain for Federal income tax purposes) should be treated as ordinary income under section 1258. See Argument for Issue 3, infra.

The Contracts reference, as the assets to be sold, short-term bonds (which the transactional documents also refer to as "certificates of deposit") that have LIBOR-based variable yields. The Contracts, however, provide for a two discrete payouts: (1) the guaranteed Protected Rate Payments that offset all Loan payments; and (2) Additional Payments that are only due if the Market Rate exceeds the Protected Rate. The Protected Rate Payments were designed to serve no economic function for investors in the Transaction other than to provide a quarterly payment stream that was guaranteed to offset, dollar for dollar, the investors' obligations under the Loan. The promotional materials reflect that investors in the Transaction had no upside potential or downside risk from this portion of the Contracts, other than the upside of the resulting tax benefits. We have concluded, with ample authority under case law, that the Loan lacked genuineness due to the Loan being offset by the Contracts. Likewise, we conclude that the Contracts' Protected Rate Payment component lacks genuineness for its intended purpose of offsetting the Loan, and may be disregarded.

We also note that the Contracts fail to function as forward contracts.[32] The referenced assets in the Contracts are bonds that are both short-term and yield a LIBOR-based variable rate that adjusts with market conditions, i.e., assets that are not expected to fluctuate in value. The Protected Rate Payment provision in the Contracts, however, guarantees payments that were set at a rate in excess of LIBOR when the Contracts were entered into, thus providing a payment stream that is unrelated to the value of the Contract's referenced assets.[33] Whereas payments upon execution or termination of a forward contract should reflect fluctuations in the value of the referenced asset, the guaranteed Protected Rate Payments from the Contracts indicate that the Contracts are not forward contracts. The function of the Protected Rate Payment provision is to provide a guaranteed payment stream to offset the Loan, rather than to obligate the parties to purchase or sell identified assets in the future at a predetermined price. In this vein, the Contracts' guaranteed Protected Rate Payments are more akin to payments on a fixed rate loan that mirrors and offsets Taxpayers' obligation under the Loan.

After disregarding both the Loan and the Protected Rate portion of the Contracts, we are left with the only portion of the Transaction that has any substance, i.e., the Taxpayers' right to receive Additional Payments if the Market Rate exceeds the Protected Rate. Not surprisingly, the parties who have purchased an interest in the Transaction since its inception have paid a price that approximates the value of this right, which is reflected in the value of the swaption that Broker holds to meet its obligation under the Contracts. The objective economic reality is that Taxpayers actually purchased an interest in a swaption contract, and nothing more. Taxpayers cannot alter this "given result" by taking a "devious path." Minn. Tea Co, 302 U.S. at

[32] Neither of the legal opinions provided to Taxpayers addresses whether the Contracts qualify as forward contracts for tax purposes.

[33] Accordingly, even if the Transaction was not recharacterized as the mere right to receive swaption payments, no inference should be drawn that the Service considers any portion of the Contract's quarterly payments to be "gain" for Federal income tax purposes.

613. Additional Payments from the Contracts, if Taxpayers receive any, are payments from a swaption and will generally be subject to the rules governing notional principal contracts. See Treas. Reg. § 1.446-3(c)(1)(i) (defining "notional principal contract" as providing "for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts").

C. Rev. Rul. 2003-97, 2003-2 C.B. 380, is not applicable

Rev. Rul. 2003-97 addresses the deductibility of interest on a five-year note issued as part of a "unit" that also included a three-year forward contract to purchase stock of the note's issuer (Corporation X). Holders must make an initial payment to acquire the unit, and must pledge the note they receive to secure their obligation to pay on the forward contract. The ruling explains that "[a]ll of the interest payments on all of the Notes will be made in cash." The Holder could separate the note from the forward contract by pledging other collateral, and it is "substantially certain" that the notes will be remarketed and remain outstanding after the forward contract is settled. The ruling holds that the note and forward were separable instruments, that the note qualifies as debt for tax purposes, and that the interest that Corporation X paid on the notes is deductible.

The legal opinions provided to Taxpayers cite the ruling for the proposition that the Loan and Contracts in the Transaction must be honored separately. The legal opinions focus on Broker's right to sell or assign the Loan to a third party. Moreover, the "Risk Management Consulting Technical Discussion" that potential investors in the Transaction received analyzes the ruling as follows:

> The fact that [the Transaction] is highly leveraged does not in any way change its nature or its tax characteristics. Revenue Ruling 2003-97 addresses a similar Leveraged Forward Contract and affirms that the Forward Contract and the Note must each be taxed according to their own individual character.

The legal opinions and Technical Discussion fail to address the distinctions between the facts in the ruling and the facts surrounding Taxpayers' purchase of the Transaction. In the ruling, the holder of the note pays out-of-pocket for the note, and receives quarterly interest payments from Corporation X in cash. Thus, the ruling does not describe offsetting circular flows of cash comparable to those that are present in the Transaction, and it is those circular flows of cash that serve as the primary basis for our disregarding the genuineness of the Loan.[34] Moreover, the ruling explains that that the note is expected to remain outstanding even after the forward is settled, whereas the

[34] The holder of the forward contract in the ruling is also the holder, rather than the borrower, under the note. Actual money changes hands in the ruling when the note is issued because the holder is not borrowing to collateralize its obligation under the forward contract. In contrast, Taxpayers are the borrowers under the Loan, which means that Taxpayers are effectively borrowing the amount that they pledge under the Contract and never pay that amount out of pocket.

Transaction was designed so that the Loan and the Contract would make offsetting payments for an identical term, expiring together. In addition, it is also highly unlikely that the Loan and the Contract would ever be separated, since no rational investor in the Transaction would ever post substitute collateral for the Loan in lieu of the Contract, and few could afford to do so, given the principal balance of the Loan. Likewise, the fact that BrokerSPE could theoretically sell the Loan to a third party is irrelevant, since no rational investor would purchase the Loan unless it was secured by the Contract or similar collateral.

Given these factual differences, Rev. Rul. 2003-97 is not controlling. The Loan and the Contracts in this case were designed to offset, requiring no payments by any investor, except for fees and the cost of a swaption that served as the only real part of the Transaction. As explained, Taxpayers merely purchased the right to a return under swaption contracts (albeit paid indirectly by BrokerSPE), and should be treated as such for tax purposes.

Issue 2: Alternatively, whether the "at-risk" rules set forth in section 465 apply to limit Taxpayers' losses claimed in connection with the Transaction

Some or all of Taxpayers' claimed deductions may be disallowed under the at-risk rules set forth in section 465.

Section 465(a)(1) provides that, in the case of individuals and certain C corporations that are personal holding companies under section 542, any loss from an activity shall be allowed "only to the extent of the aggregate amount with respect to which the taxpayer is at risk . . . for such activity." Section 465(b)(1) provides that a taxpayer shall be considered at risk for an activity with respect to the amounts including (A) the amount of money and the adjusted basis of the property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity. Section 465(b)(2) provides that a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he (A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount.

Section 465(c)(3) provides that this section applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. A broad reading of the term "activity" thus results in a taxpayer having more amounts at risk.

The terms of the Loan in this case provide that the borrowers are personally liable for repayment but, due to the structure of the Transaction, the Loans are effectively nonrecourse. Since the Loan is collateralized with a Contract that is created to make all payments on the Loan, investors in the Transaction will never be personally liable to repay the Loan. This is consistent with the promotional materials' characterization of the Transaction as "Not an 'investment'," with "No market risk," and as never requiring the investor "to come out of pocket for any additional money." Accordingly, Taxpayers cannot include the Loan for purposes of determining the amount they have at risk in the Transaction.

The legal opinions provided to the Taxpayers were not addressed to Taxpayers, nor do the opinions address Taxpayers' business or income producing activities when Taxpayers invested in the Transaction. Moreover, the opinions implicitly concede that the loans are nonrecourse by not addressing the issue. Rather, the opinions focus on the scope of the investors' "activities." For the LawFirm opinion letter, the activity in issue is the investor's activity of "managing an investment portfolio," and the opinion includes the Transaction as part of that activity. In the SoloP opinion letter, the activity in issue is the investor's "results-based marketing company," and the opinion includes the Transaction as part of the investor's trade or business.

With respect to Taxpayers' participation in the Transaction, we note that the determination of a taxpayer's activities under section 465(c)(3) depends upon the specific facts of each case. We understand that Promoter marketed the transaction to individual professionals, such as doctors, lawyers, and teachers. Taxpayer-X was a recently laid-off manager at a manufacturing plant, while Taxpayer-Y reported self-employment income for activities as a voice over artist and for officiating over weddings. Although section 465(c)(3)(B) provides for aggregation of activities that constitute a trade or business, Taxpayers' participation in the Transaction is not in furtherance of any of Taxpayers' trade or business activity, and should not be aggregated with those activities for purposes of avoiding the at-risk limitations of section 465.

Accordingly, the at-risk rules will limit Taxpayers' deductions claimed with regard to the Transaction, subject to additional factual development regarding Taxpayers' activities.

Issue 3: Alternatively, whether the Contract is a "conversion transaction" pursuant to section 1258

Section 1258(a) provides that gain recognized on the disposition or other termination of any position held as part of a conversion transaction is treated is ordinary income (to the extent such gain does not exceed the applicable imputed income amount).[35] Section 1258(c)(1) defines a "conversion transaction" as any transaction "substantially all of the taxpayer's expected return from which is attributable to the time value of the taxpayer's net investment in such transaction," and section 1258(c)(2) further requires that transactions must fall into one of four categories in order to be treated as conversion transactions. Among those categories is any transaction "which is marketed or sold as producing capital gains from a transaction described in [section 1258(c)(1)]." Section 1258(c)(2)(C). The legislative history explains the focus of section 1258 as follows: "In a conversion transaction, the taxpayer is in the economic position of a lender – he has an expectation of a return from the transaction which in substance is in the nature of

[35] Section 1258(b) defines "applicable imputed income amount" as effectively taxing as ordinary income an amount equal to the amount of interest that would have accrued on the taxpayer's net investment.

interest and he undertakes no significant risks other than those typical of a lender." H.R. Rep. No. 103-111, at 637 (1993).

If the Contracts qualify as conversion transactions, then gains recognized from the Contract are taxed as ordinary income to the extent such gains do not exceed the amount that Taxpayers would have earned if their net investment in the Transaction yielded 120 percent of the applicable federal rate. "Net investment" in the Transaction includes the principal amount of the Loan. See Id. at 638 (including borrowed amounts as an example of net investment in a conversion transaction).

As discussed, the guaranteed Protected Rate Payments from the Contracts matched the principal and interest on the Loan. The Protected Rate Payments represented a return of Taxpayers' net investment in the Contract, payable at a fixed interest rate. Therefore, we conclude that Taxpayers' expected gain from the Contracts (to the extent allocable to the Protected Rate Payment) is solely attributable to the time value of money for purposes of section 1258(c)(1). In so doing, we note that the Contract is consistent with transactions that Congress intended to target when it enacted section 1258; Taxpayers expected an interest-like return, and they undertook "no significant risks other than those typical of a lender." H.R. Rep. No. 103-111, supra, at 637.

With regard to whether the Transaction falls into one of the four categories enumerated in 1258(c)(2), the legal opinions provided to Taxpayers contain the following factual assumption:

> You have represented . . . that no party described or marketed to you the Forward Contract or the combination of the Forward Contract and the Secured Loan as a means of obtaining capital gain treatment for gain that is attributable to the time value of your net investment in the Forward Contract and Secured Loan.

This representation is contradicted by the marketing materials, which explain that there is "[n]o market risk" and that "loan payments are matched to the minimum payments guaranteed by the Forward Contract." The materials further project "After-Tax Net Cash Flow" due solely to exploiting the difference between deducting payments of interest on the Loan at ordinary rates (assumed to be 35%), and including in income the matching receipts under the Contracts as long-term capital gains (assumed to be taxed at a 15% rate). We conclude that, for purposes of section 1258(c)(2)(C), the Transaction was marketed or sold as producing capital gains out of a transaction described in section 1258(c)(1).

Accordingly, we conclude that section 1258 applies to the Taxpayers' participation in the Transaction, and any gain from the Transaction, up to the applicable imputed income amount, will be taxed as ordinary income.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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Please call (202) 317-6842 if you have any further questions.

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